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Transmitted Electronically and Regular Mail

Mr. Richard J. Williams
Director, Division of Economics and Finance
Virginia State Corporation Commission
P. O. Box 1197
Richmond, Virginia 23218-1197

**Re: Response to Letter Dated April 24, 2002**

Dear Mr. Williams:

By this letter Washington Gas Energy Services, Inc. (WGES) responds to your letter dated April 24, 2002 soliciting ideas from stakeholders in retail electric markets in Virginia. Staff seeks ideas that may assist the Commission in the preparation of a second annual report to the Legislative Transition Task Force and the Governor as required by §56-596 B of the Virginia Electric Utility Restructuring Act. WGES welcomes and appreciates this opportunity.

You note that the report will cover three topics: (1) the status of competition in the Commonwealth, (2) the status of the development of regional competitive markets, and (3) recommendations to facilitate effective competition in the Commonwealth. You also list a number of specific questions to which you would welcome input. Below, WGES provides a general response to the three topics noted and specific answers to the questions posed.

General Overview

WGES applauds the goal of electricity market deregulation in Virginia. Unfortunately, the desired objectives of increased competition and lower prices for consumers have not yet been achieved. The availability of a contestable electricity market is necessary for there to be progress toward the fully competitive retail electricity market that the Virginia Legislature and the Commission envision.

A contestable power market can be viewed as one in which non-utility power generators such as independent power producers and exempt wholesale generators can serve the same load or market demands without restrictions or retaliation by incumbent firms and employ similar technology as those used by the incumbent firms. Contestable power markets have been the cornerstone of electricity industry restructuring. Generally, energy regulators and legislators have recognized and affirmed this fact and rightly so. Power generation has been and is deemed to be a market area that can be opened to competition without jeopardizing the integrity of the supply system. As a result, power generation has been treated as a competitive service while transmission and distribution remain unchanged as monopoly utility functions.

Furthermore, whether or not a power market is contestable can be determined from an analysis of the market structure or the competitive environment in which competitive suppliers must operate. In this analysis, the size and number of utilities and competitive suppliers can be small and yet the market can still be contestable. Indeed, a contestable market by its very nature would encourage the entry of new suppliers, thereby increasing competition. In a non-contestable market, suppliers would instead refrain from participation in the market altogether. *A market that is contestable will attract competition.*

WGES submits that in its current form, the Virginia retail electricity market is not contestable primarily because of the prevailing market structure. The lack of viable competitive energy service offerings at this time is ample evidence that the Virginia market model is not yet conducive to competition.

WGES urges the Commission to focus on establishing market features that will make the market contestable rather than on existing comparative prices, although the current prices to compare are a major roadblock to supplier entry. Whether or not a competitive supplier is likely to enter the retail electricity market depends upon whether the supplier believes that the delivered price of electricity is greater than the supplier's own costs. It is a given fact that consumers are intelligent and can choose the best or the lowest price of a homogeneous product or service such as electricity or natural gas. As a case in point, there has been little positive response from licensed retail electricity suppliers to the 2002 utility "price to compare" information released on January 10, 2002 by the Commission.

A competitive electricity market requires a framework that permits sellers and buyers to entertain various offers and strike the best deals. Therefore, an ideal market structure would eliminate the current price to compare distortions. The Commission should strive to establish a retail electricity market with the following characteristics:

(1) The "price to compare" should be market based and set for the duration of Standard Offer Service.

(2) Competitive suppliers and buyers should have complete knowledge of market prices at the same time. Hence, price discovery and transparency in highly liquid markets are preferred over closed pricing under private bilateral contracts.

(3) The elimination of entry barriers and the attendant promotion of the free mobility of resources and free strategic decision making by competitive firms.

With such a market structure, the degree of "costless" exit from retail electric power markets in Virginia would depend mainly on the degree of sunk costs faced by a competing firm only, not on the market power of utility competitors or regulatory impediments that prevent entry in the first place.

(4) Rival suppliers should have the ability to evaluate reasonable pre-entry prices such as utility standard offer service prices approved by the Commission. The pricing of standard offer service should reflect an amortization schedule of stranded cost over a fixed period of time for each utility. The Commission should define recoverable stranded costs for each utility in the state. Determining total recoverable stranded costs with an appropriate amortization schedule is the best way to allow for utilities to recover stranded costs without defeating competition.

At the present time, the development of a competitive retail electricity market in the Commonwealth has stalled. The development was actually stalled from its inception largely due in part to the fact that the "prices to compare" set by the Commission in the process of establishing wires charges for each utility are well below prevailing market prices for power. If competition is to begin in earnest in the Commonwealth, the calculation of the "wires charges" that underlay unrealistic and non-market "prices to compare" must be changed.

At the same time, WGES does not support creating artificially high "prices to compare" that would exceed an electric utility's true unbundled cost of generation and transmission. That also would produce economically inefficient results. However, if wires charges are currently being set in such a way that the resulting "prices to compare" are below the market price, true retail competition cannot begin.

Beyond this threshold issue, there are certain provisions of Dominion Virginia Power's Open Access Transmission Tariff that make the importation of cost-effective generation supplies difficult if not impossible. This is particularly true of the requirements imposed under that tariff for firm transmission contracts that can bring power to the Virginia Power interface and of the penalties under the tariff for hourly imbalances that operate to stall competition as well.

WGES believes that the Virginia Legislature, the Governor, and the State Corporation Commission should focus their efforts on addressing these two fundamental issues – the setting of appropriate utility prices to compare and the establishment of fair transmission tariff provisions. Both are essential to establish a proper market structure and foundation for retail competition. Only then will it be worthwhile to further refine the other necessary features of competitive retail electricity markets.

WGES further believes that the Virginia Legislature, the Governor, and the

State Corporation Commission should review the status of efforts to bring more electric power generation on line in the Commonwealth. A fundamental goal of retail electric competition is to complete the overall market structure needed to support the development and use of cost effective generation sources. To the extent that the construction of new generating capacity is delayed, the long-term benefits of competition will be delayed.

Responses to Questions:

1. Significant obstacles to the development of a robust competitive retail electricity market for residential, commercial and industrial customers.

The most significant obstacles to the development of a robust competitive retail electricity market are below market prices to compare and transmission rules that are unduly restrictive. Other significant obstacles include: (i) the setting of wires charges that cause below market prices; (ii) the lack of a functioning ISO for handling imbalances and ancillary services; (iii) the lack of generation available for the deregulated market, and (iv) the lack of a contestable market that attracts competition.

2. The necessity of RTOs to a properly functioning competitive retail market in Virginia.

Regional Transmission Organizations (RTOs) clearly help the development of competitive markets. However, fairly administered Open Access Transmission Tariff rules in the absence of RTOs also enable competitive suppliers to enter the market. Hence, while an RTO does appear to be essential for a competitive market to function properly, transmission utilities like Dominion Virginia Power should set up interim processes that support supply efforts until an RTO is actually in place. Such processes would include providing flexible energy balancing terms and all ancillary services.

3. The necessity of standardized transmission service and market design.

A properly functioning, independent power exchange would clearly help the development of competitive markets. Since bordering states have such markets, however, the opportunity exists to tie hourly price settlements to those markets as an effective interim surrogate. This is especially applicable to Dominion Virginia Power's border with PJM. The establishment of a standard market design for wholesale electricity markets will encourage a more orderly and efficient development of competitive markets as operating rules will be consistent across different regions.

4. The need to modify the rules governing retail access.

While retail access rules could be improved, WGES believes that rules in Virginia are not currently impeding the launching of the competitive retail electric market. Suppliers like WGES are adjusting to the demands of complying with the retail access rules that fairly balance the need for consumer protection with the need for suppliers to compete effectively.

5. The effectiveness of the Commission's Energy Choice consumer education program.

It is unclear if paid advertising can be effective in promoting retail electric choice at least until the price to compare and transmission issues are resolved. Currently, consumers are paying for media programs that are not supported by available choices. Customer education spending will be most effective if it coincides with customers receiving competitive offers. Therefore, the public media campaigns should be scaled back until market offerings support the Energy Choice programs.

6. Policies regarding aggregation and the development of competitive retail electricity markets.

WGES believes that aggregation will be ineffective in promoting the development of competitive retail markets until the price to compare and transmission issues are addressed and resolved.

7. Customer option to return to utility service and pay market based prices.

A "market based" price offering that allows customers to avoid minimum stay requirements is a good feature that the Commission should encourage.

Commercial customers returning to the utility should have the option to pay a market rate from the utility until they choose a new supplier. There can be a variety of situations that can cause customers to return to the utility, while they may still want to purchase energy from a competitive supplier. Small mechanical issues involving EDI transactions or decisions by a customer or the competitive supplier could lead to this situation. If customers desire to return to non-utility supply, they should have the option to avoid a "minimum stay" requirement. Residential customers should not be subject to "minimum stay" restrictions at all.

8. Projected market prices for generation reflected in the establishment of wires charges under §56-583.

The setting of the wires charge is a key issue that is preventing the progress of retail competition in the Commonwealth at this time. The legislature should revise the entire mechanism for setting the wires charges to be consistent with models developed in other States in the Mid-Atlantic region. Wires charges should be driven by retail distribution costs and market forces should determine the retail prices.

The wires charge and standard offer mechanism should be built on the following three steps, as previously stated: (i) determine the needed level of stranded cost recovery for each utility, if any; (ii) select a transition period and an amortization schedule over which each utility will collect stranded costs, if any, through a "wires charge"; and (iii) at the end of the transition period, all electric supply to retail customers should reflect market pricing and be provided by competitively chosen suppliers. This model would present complete clarity to the market in terms of the costs and duration of utility standard offer service. It therefore would promote the development of the competitive market. It also would avoid the requirement of projecting market prices of any type, and allow customers to compare true market prices to the standard offer service benchmark.

9. Richmond Times Dispatch article concerning retail choice.

As reflected in the answer to the previous question, the assertion in the article – namely, that there is no measurable competitive activity in service territories open to retail choice and that the wires charge identified by competitive suppliers is a barrier to entry -- is completely correct.

10. Use of a Fund as a mechanism whereby rate caps could be incrementally increased to facilitate market development.

WGES does not believe that non-market prices set by utilities or regulators ultimately improve the development of competitive retail markets. The objective should be for the retail market to experience true market prices from all suppliers as soon as practical. WGES favorably views increasing rate caps but doubts the efficacy of the proposed "Fund."

11. Price caps and effective competition.

The utility should have a standard price regulated by the Commission. During the transition period, this price should be capped to protect the consumers until the market develops. See also the answer to question #8 above for WGES' recommended model for competition.

12. Role for regulation in the promotion of demand-side participation by customers.

To the extent that demand side management can reduce the cost of distribution, there is a role for regulation in providing incentives to customers. To the extent that demand side management affects the cost of generation supply, it should be left to the competitive market as regulated generation supply is phased out.

More real-time or time-of-use metering would be a good direction for the general consumer, especially in the face of the growing popularity of load management, real time pricing and demand response programs. Appropriate price signals could then be developed through "time of use" rates and interval metering for larger accounts that could then demonstrate that they reduced load during peak periods.

13. Retail markets in the service territories of electric cooperatives in Virginia.

Generally, WGES believes that electric cooperatives should allow their customers to be served through the same retail access processes as apply to the rest of the state. The exemptions afforded electric cooperatives under the Restructuring Act as referenced in this question will allow the cooperatives to control and limit competition in their markets. Ultimately the exemptions should be reconsidered by the legislature if competition is thwarted.

14.a. Rhode Island proposal.

WGES does not support local government "opt-out" aggregation. This effectively substitutes one government controlled price/service offering for another. While this approach has migrated blocks of customers to one or two suppliers in Ohio, it has not created a broader, more competitive market place.

14.b. Maine PUC auction to determine standard offer.

An annual bid for "standard offer" is a possible variation of step #3 in the process outlined in question #8 above. Another variant would be the New Jersey model of bidding basic generation services.

14.c. PUCO agreement with First Energy.

WGES does not support introducing new forms of non-market prices into the development of the competitive retail market.

Other actions that could advance competitive activity in Virginia.

WGES believes that the regional models developed in many East Coast contiguous states are appropriate transition models for the Commonwealth. They include restructuring models in New Jersey, Pennsylvania, New York and Massachusetts, for example. In many of these cases, the market structure is conducive to the development of competition, and consumers are able to shop around and make money saving deals.

Ideas tried elsewhere that may facilitate competitive activity in Virginia.

WGES believes that consistency across states in market development strategies offer the best opportunity for facilitating competitive activity.

Respectfully Submitted,

Harry A. Warren, Jr.
President
Washington Gas Energy Services